RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Post Office Box 1759, La Jolla, California 92038

26 Letters Per Year • $250 annually

Aug. 12, 1998 **LETTER 1258**

THE PICTURE: Russell's warning: **"In a bear market, whatever can go wrong will go wrong."** This adage explains why bear markets often end up lower (more costly) than anyone thinks possible at their inception.

ENTER THE BEAR: On July 29 the **D-J Transportation Average** broke under its June low. This constituted **one-half** of a primary bear signal. The **other half** of the bear signal occurred on August 4, when the **Dow,** on huge and authoritative volume of 836 million shares, plunged below its June low-closing of 8627.93. The penetrations of the June reaction lows by both Averages complete a bear signal. **Under classic Dow Theory, a primary bear market is now in force.**

Amazingly, or perhaps coincidentally, on the same day (August 4) my **Primary Trend Index (PTI)** dropped below its 89-day moving average. This placed the PTI in the "sell" position. For the first time in over four years, the PTI is now in its bear mode (see page 2 chart).

Question: Russell, why didn't you send out a "Special Mailing" when you received the bear signal?

Answer: I didn't think one was necessary. Ever since early-April I've been warning of the dreadful breadth picture. In the last Letter I stated over and over again that "if the Dow breaks below **8627.93,** that will constitute a primary bear market signal." On top of that I stated in the "Investment Position" section of the last Letter that it is not necessary to wait for an actual bear signal before selling out. Finally, following the bear market signal of August 4 I wanted to give the situation a few days to develop before writing something. Honestly, I don't know what else I could have done except personally call each subscriber's broker and actually give the order to sell.

Question: Russell, how would you describe what had happened in the stock market up to the time of the actual bear market signal?

Answer: What we experienced following the April 3 peak in the A-D ratio was what I would term "a breadth crash." Almost all non-blue-chip stocks headed lower, and lower with a vengeance. In fact, the *WSJ* noted (mid-July) that the average stock on the NYSE had lost 24% from its 52-week high while on the Nasdaq the average stock had lost about 32% from its 52-week high. In other words, a hell of a lot of losses were piling up even before the bear signal of August 4. Only the big, blue-chip stocks and the super-tech stocks had avoided serious damage.

For Thousands of Stocks, Bear Market Is Here

By Gene Ip And Aaron Lucchetti Staff Reporters of The Wall Street Journal

For thousands of stocks, the bear mar...

Looking Inside the Stock Market

Benchmark Indexes Haven't Corrected—Except for the Russell 2000 ...

... to the largest. Just 78 stocks provided al... the year-to-date return of the S&P 50... through Tuesday, according to Salomon Smith Barney; the gainers in the remain... [illegible] Indeed, onl...

Question: So with all those losses in secondary stocks, wasn't it obvious that a bear market was in progress?

Answer: No, it was not. As I saw it, the bull had been badly wounded, and he was staggering about on three wobbly legs. But I could not call it a confirmed bear market until the sword had been plunged into the heart of the bull. That occurred with the Dow Theory bear signal of August 4.

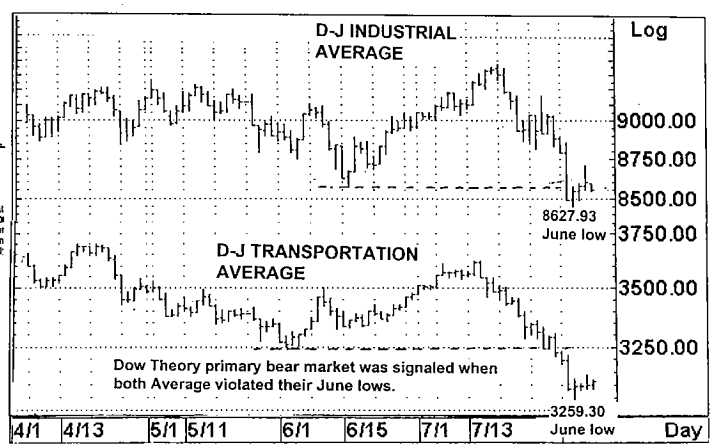
July 31 DJIA 8883.29; PTI 5329; A-D Ratio +8.10
Aug. 7 DJIA 8598.02; PTI 5325; A-D Ratio +7.43
Dow Yield: 1.71%; Dow Price/Earnings: 21.8
Dow 144-day MA: 8737; Dow 34-day MA: 8900
Dow Times Book Value: 5.39; PTI 89-day MA: 5324
Percentage of Undervalued Blue-chips: 4%
Gold 34-day MA: 296

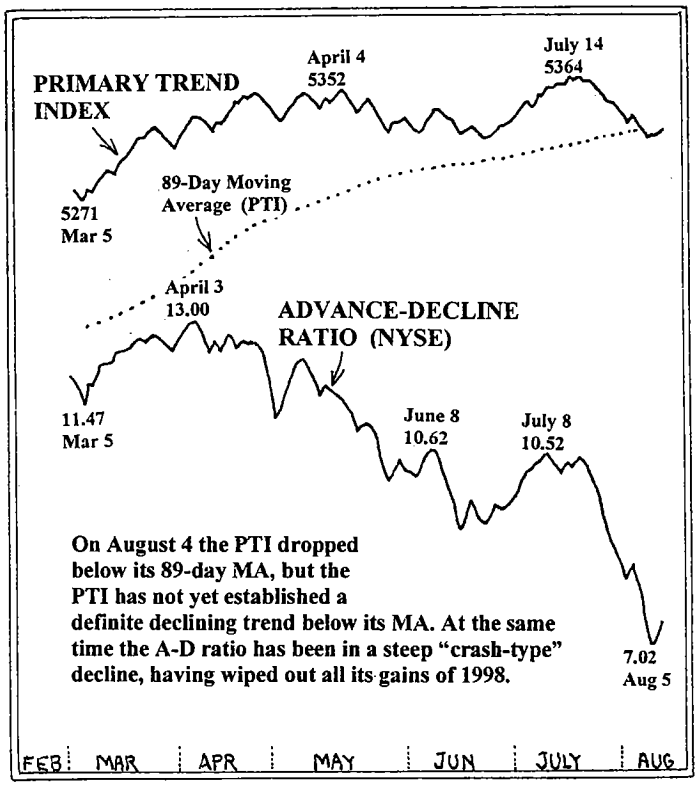
Question: What about your **Big-Money Breadth Index (BBI)?** Is this telling us anything?

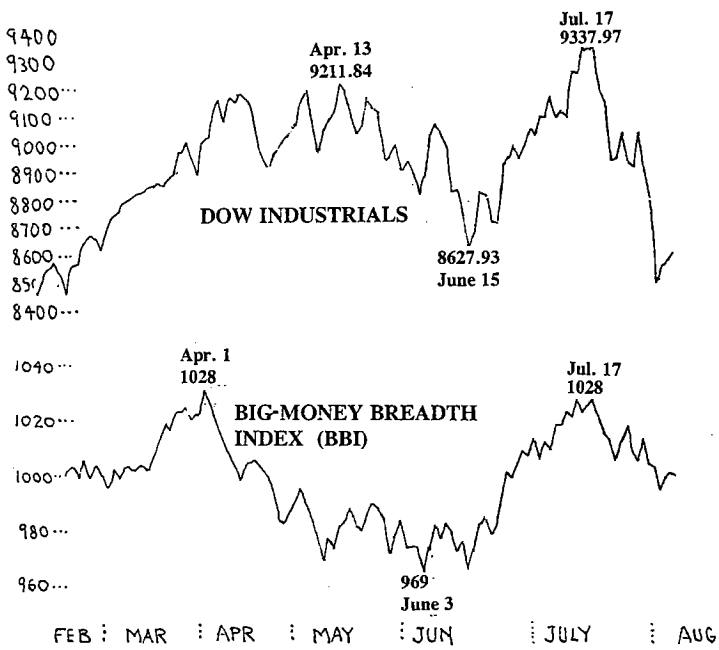
Answer: I think it is (see page 2 chart). Note that the BBI topped out on July 17, at exactly its April 1 peak level. Note also, however, that the BBI has **not yet broken** below its June 3 low of 969. Since this is a bear market I have to think that the BBI is fated to break to new lows. But here's what I think the BBI is telling us. It's telling us that despite the Dow Theory bear signal, despite the decline in the majority of stocks, the big stocks have not yet "thrown in the sponge." When the BBI finally does break below its June 3 low it will feel like the back of the market has been broken. That's when we'll see the big, blue-chip stocks come down in earnest. That's when the stock market will really look as though the bear is in command. The BBI, currently still holding above its June 3 low, is telling us that this initial phase of the bear market is still the "polite" phase. The polite phase will last as long as the BBI holds above its June low.

PRIMARY TREND: For newer readers, I want to include a brief discussion of the all-important primary trend. The primary trend is the **single most powerful force** in the market. When the primary trend is bullish, almost all stocks will ultimately work higher. A bullish primary trend makes a hero of all buyers. A primary bull market ultimately rectifies all mis-timed purchases and in time wipes out all mistakes.

Conversely, a primary bear market is both a bearer and a generator of bad news. When a bear market moves in following a big bull market, buyers will be slowly and systematically parted from their assets. Unfortunately, much of the parting tends to come at, or close to, the bottom of the bear market. I've said this before but I'll repeat it -- just as a bull market "wants" to advance while taking as few participants as possible with it, a bear market wants to decline while taking as many participants as possible down with it.







For an accurate concept of the primary trend, think in terms of the great tide of the ocean. Once the tide comes in or runs out, nothing will stop it from expressing itself. Next, think of the waves as the secondary reactions (corrections) which occur within the tidal movements. Finally, think of the little ripples on the waves as the daily movements of the market. The daily moves are often random, often meaningless, usually set off by an over-bought or over-sold situation or by the news of the day.

DOW THEORY: I think this is a good time to review some Dow Theory. The crux of Dow Theory has to do with two distinct concepts. The first pertains to the **psychological phases** of a bull or bear market. Since we've been dealing with a bull market, I will outline the three psychological phases of a bull market. The first phase of a bull market is the recovery from the previous bear market's final depressing, oversold lows. In the first phase, only seasoned, value-wise investors have the courage to buy.

The second psychological phase of a bull market is generally the longest phase. This is the phase where stocks rise as they discount gradually improving business conditions plus rising corporate profits. In the second phase a small but growing segment of the public starts to enter the market. Confidence grows, but it grows slowly. The second phase is characterized by one or more severe secondary reactions.

The third and final phase of a bull market is the speculative phase. This is the phase where volume surges and where the public enters the market wholesale. This is also the phase where stock yields shrink, where price/earnings ratios surge, where sentiment becomes frothy, and where it is widely believed that a "new era" has arrived.

Now this is important -- **it is only in the third phase of a bull market where a Dow Theory bear signal is valid.**

This stock market had been in its third psychological phase for many years. In fact, this is without question **the longest third phase** of any bull market in history. Why such an extended third phase? The answer in my opinion -- the wholesale emergence of mutual funds and the public's total acceptance of the mutual funds.

OK, I've described the psychological-phase portion of Dow Theory. Next -- the **price movement** portion of Dow Theory. The crux of the price movement part of Dow Theory concerns what happens AFTER a secondary correction. In the current instance, the Averages (Industrials and Transports) underwent secondary corrections starting in early April and ending in June. From their June 2 low, Transports rallied to a July 14 peak. At the July 14 peak it was seen that the Transports had failed to advance above their prior April 16 high. In the face of this bearish failure, the Transports turned down again.

The Industrials started up from a June 15 low. By July 17 Industrials had climbed to a new record high. The new Industrial high was NOT confirmed by the Transports. From their July highs the two Averages turned down again. On July 29 the Transports violated their June lows. The Industrials confirmed on August 4. A bear market was signaled under Dow Theory.

Question: Russell, it's obvious that the big money has been playing it very conservatively this year, meaning that the big money has been funneling their assets into the "safe" blue-chip stocks all the while forsaking the secondary and less-than big-cap stocks. This has resulted in continued deterioration in the majority of stocks, as tracked by the advance-decline ratio. So question -- can a continued decline in the advance-decline ratio cause the entire stock market to top out?

Answer: The A-D ratio tracks the advancing or declining tendencies of the **majority** of stocks on the NYSE. When the A-D ratio declines on a trend basis, as it has been doing since April 3, we call this "internal weakness." I stated in the Letters that the breadth performance following the April 3 high was "one of the worst I had ever seen." I said that if it continued, it would pull everything down with it. I compared it to "the water running out of a bathtub once the stopper was pulled."

Question: OK, Russell, the Averages have signaled a primary bear market. So the question is, "How low would you expect the market to go?"

Answer: A tenet of Dow Theory states, **"Neither the duration nor the extent of a primary movement can be predicted in advance."** For instance, nobody 18 years ago foresaw the Dow rising from 759 in 1980 to 9337 in 1998. By the same token, when the primary trend turns bearish nobody can predict where the market will go on the downside. Here is my own observation: Every primary bear market in history has wiped out

at least half of the preceding bull market's gains. I mark this great bull market as having started in 1974 at Dow 577 -- with the recent high this year at Dow 9337. If the Dow was to wipe out just half its 1974-'98 gains the Dow would decline to 4960 or lower.

Or suppose the Dow was to decline to the point where it yielded say 3% (and a 3% yield was actually the old danger level for Dow). If the Dow was to yield 3% it could easily be cut in half from its high of 9337. The point is this -- it is **very dangerous to have preconceived notions** as to how far the Dow will rise in a bull market or how far the Dow will fall in a bear market. In most cases, you're going to be wrong -- very, very wrong.

Question: Russell, I note on CNBC that most of the commentators are rather casual about what has happened. Almost nobody mentions the bear signal or the words, "primary bear market." And many of the analysts who are interviewed talk about a "much-needed correction," or maybe the Dow dropping into the high 7000s, at which point the market will be very sold-out and a screaming buy.

Answer: The great majority of these analysts have never lived through a bear market. They don't understand how a bear market works. So in most cases they're simply "talking through their hats." Furthermore, in many cases their jobs are on the line, and in bear markets Wall Street tends to clean house -- and, of course, these analysts are well aware of that. Thus, there is tremendous pressure on these analysts to remain "constructive" or bullish.

Question: Here's what I don't understand. Business is still good. Housing is very good. Consumers are still optimistic and they're spending their heads off, so how could we have a bear market. Let me put it another way -- what could go wrong?

Answer: First of all, the reasons for a bear market are only known months after the market starts down. Therefore, it would merely be a guessing game for me to list the items that might underlie this bear market. I know that the "experts" are blaming most of the selling on trouble out of Asia and trouble out of Washington. But those two items have probably been fully discounted by the market already. No, my guess is that many other items will turn out to be important factors in the bear market. Remember, the stock market isn't interested in yesterday's news or today's news, the stock market deals with tomorrow and next week and next month. So forget Asia and Washington as reasons for this bear market, the ultimate trouble will be far different but just as serious, if not more so.

Here are a few situations that I don't like at present: **(1)** The American public has literally no liquid savings. If the bear market progresses, the public will be forced to sell their stocks or their mutual funds. **(2)** The mutual funds themselves are fully invested. They have very little cash. If the funds receive redemptions, and they will, at some point they'll be forced to dump stocks on the market. **(3)** I discussed this in the last Letter but I'd better repeat it. The big swinger in both bull and bear markets is not earnings, it's the price/earning ratios. These ratios at the June highs (Dow, S&P) were around 30, the highest ratios ever seen in a bull market. And of course these extremely high ratios reflected extreme optimism. In a bear market the price/earnings ratios will head lower. If P/E ratios drop to a more normal 15-17, the market could be cut in half. And in some severe bear markets, P/E's dropped as low at 10. **(4)** I started this Letter with the comment that "in a primary bear market whatever can go wrong will go wrong." Believe it. **(5)** Unfortunately, just as there is a "wealth effect" in a bull market, there is a "bankruptcy effect" in a bear market. This is particularly true because the bear loves to strike at a time when most people and most businesses are unprepared. Referring to the current situation, nobody has ever seen a primary bear market strike when 45% of US families are holding either stocks or mutual funds. Huge participation in a bull market is a marvelous thing. Huge participation in a bear market is a ticket to disaster. This bear market is hitting at a time when a record number of Americans are holding stocks and therefore a record number of Americans will be affected if their "savings" in stocks and mutual funds begin to shrink.

Question: How do you think the bear market will affect President Clinton?

Answer: It will affect him **adversely.** The US public has put up with Clinton mainly because the American public has felt good -- and they somehow equate Clinton with their good feelings and with the prosperity that they have enjoyed. A bear market will change all that, probably within a matter of months.

Question: At what point will the stock market become oversold, and at what point can we expect a good rally?

Answer: Bear markets don't work like bull markets. An oversold area in a bull market will ultimately result in a sudden reversal and a violent rally. But in a bear market an oversold area can remain oversold for weeks on end. It's exceedingly difficult in a bear market to predict the start of the next rally. The rallies seemingly spring out of nowhere, tend to be violent, and are often over in a hurry.

Question: What about the record, huge short interest in this market? Isn't that a major plus?

Answer: A big short interest in a bull market is indeed a plus for the bulls. In a bull market the short-sellers are aligned **against** the primary trend, which is usually disastrous for the short sellers. But in a primary bear market the short-sellers are aligned **in harmony** with the primary trend. Thus, a large short interest in a bear market is not necessarily a bearish situation. It simply means that a lot of traders are on the right side of a declining market. Nevertheless, selling short, even in a bear market, is a difficult and nerve-wracking procedure. When you're short you're not investing, you're playing against time. Remember, shorts are paying out dividends instead of collecting them, plus they are subject to periodic violent rallies that can quickly put them in the red. Selling short in a bear market is a lot harder than buying in a bull market.

One other comment: It is said the dullness (low volume) in the stock market identifies a "buy spot." This is true in a bull market, but NOT in a bear market. In a bear market dullness and low volume often identifies a "sell spot." Dullness in a bear market merely means that there is a lack of buyers.

Question: Russell, I note that Abby Joseph Cohen of Goldman Sachs, the analyst with the largest following on Wall Street, now says that stocks are undervalued. Could this be true?

Answer: I guess it could be true; I don't know her criteria. But Ms. Cohen is obviously dismissing the Dow Theory bear signal. She evidently doesn't believe in the stock market's predictive ability or else she doesn't believe in the validity of Dow Theory. When a bear signal is signaled under Dow Theory, the market is saying that the situation is due to **change**. The market is saying that corporate earnings are fated to decline, that price/earnings ratios are due to shrink and that business will be facing much tougher times.

Question: Russell, what do you think is going to happen in the mutual fund area if this bear market continues?

Answer: Just as the mutual funds were a force for higher prices in the bull market, I think they will be a force for lower prices in a bear market. As the bear slowly and systematically drives prices down, the funds will be forced to sell stocks in order to service their redemptions.

Investor's Business Daily's chart of 23 leading equity growth funds is worth studying at this time. At the close Friday (Aug. 7) the Mutual Fund Index was up only 4.7% for the year, thus failing to match the yield of 91-day T-bills. Note that the Index has now dropped below both its 50-day and 200-day moving averages. Note also that the relative strength line has sunk to a new low, indicating that the funds have failed all year to keep up with the S&P 500.

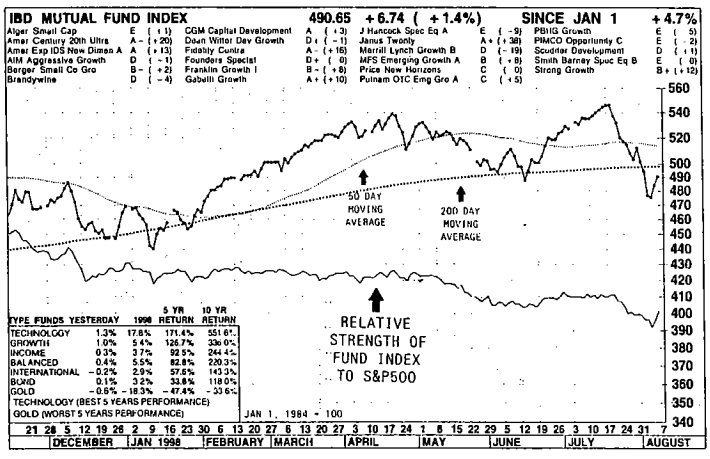
INVESTMENT POSITION: The bull is out, the bear is in. There's a huge difference between missing a move "that could have been profitable" -- and actually losing money. But most investors never learn the difference. The difference can be described in three words, "margin of safety." If the move doesn't make sense, if there isn't a margin of safety, then the best policy is to avoid the move.

To me, buying stocks here because a lot of them are "cheaper" now than they were in January, doesn't make sense. I still hear a lot of CNBC analysts talking about "new highs" by the end of the year -- but what do they really know? They're just guessing, and their guesses are no better than your guesses or mine.

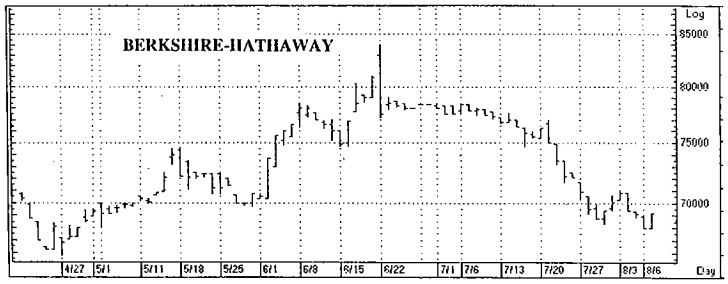
To me, this is an excellent time to play it safe. I don't care what the perma-bulls say, this market doesn't look like "a buy" to me. The truth -- right now I simply want some time to pass. Remember, and I've said this before, the bear wants to decline, but he wants to go down with one stipulation -- he wants to go down while taking as many investors as possible with him. To do that, the bear must entice, the bear must keep hopes alive, he must do whatever he has to -- to keep the level of optimism up.

This is another good concept to keep in mind: Time is the investor's enemy in a bear market. Or, to put it another way, **values tend to diminish through time in a bear market**. Thus, the bears must be patient, just as bulls in a bull market must be patient. In the stock market, nothing happens overnight. Time, time, time. **Give the bear time.** And, of course, this is why it's so difficult to sell shorts in a bear market, because when you sell shorts you're hoping that the market will collapse the next day. But it doesn't, it may not collapse for another month, and in the meantime, you're sweating out one or two violent rallies while being knocked out of your shorts.

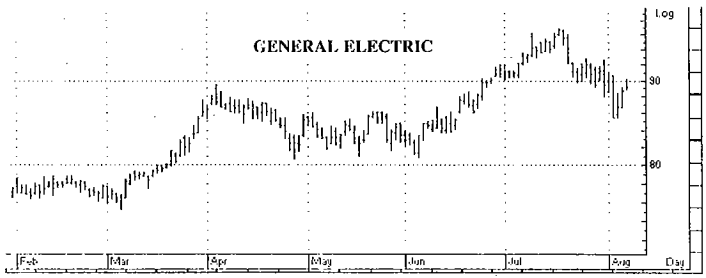
Final thought: A **Cash position** in a bear market (yes, just plain old cash) acts almost as a short position in a bear market since cash buys more and more stocks as the bear market progresses and as equities decline.


IBD MUTUAL FUND INDEX
490.65 +6.74 (+1.4%)
SINCE JAN 1 +4.7%
50 DAY MOVING AVERAGE
200 DAY MOVING AVERAGE
RELATIVE STRENGTH OF FUND INDEX TO S&P500
JAN 1, 1994 = 100
DECEMBER JAN 1998 FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST

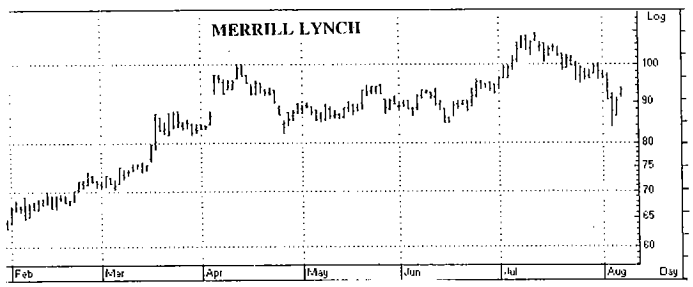
NOTES & QUOTES: Some significant stocks. For sentiment, I think Berkshire Hathaway, the ultimate glamour stock run by Warren Buffett, is a good stock to watch. Berkie is now 15% off its high. Berkie has been selling far above its intrinsic value, but day by day the stock has been coming back to earth. I thought the action of the stock was significant, like a forerunner of the stock market coming back to reality.



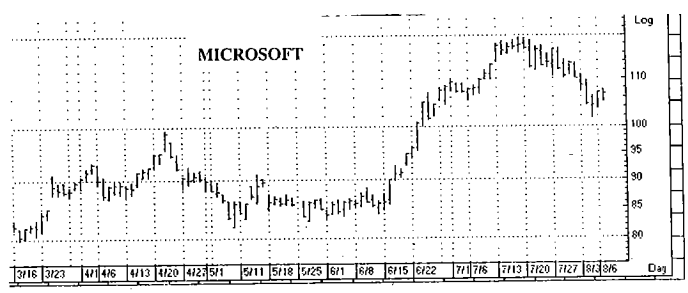
General Electric is the largest cap stock in the US (over $300 billion), so it's obviously a very important stock. During the June to July period GE spurted from 81 to 97. Right now its critical level on the downside is 85.



Merrill Lynch is another stock I watch closely. Wall Street generally knows what's happening before the rest of America does. MER is probably Wall Street's key stock. From a July 13 closing high of 107, MER has been backing off. I consider 83 a key level for MER; let's see if it can hold that level.



If there's one super-key stock in this market, it might be Microsoft. MSFT hit a closing high of 117 30/32nds on July 17. I wouldn't consider the stock in trouble unless it broke 100. If you only monitor one stock, this one's it -- so let's watch it.



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The big stocks have been getting a lot of attention this year; one reason is because a limited number of big stocks have greatly out-performed the great majority of stocks. Example: As of July 31 the Nasdaq was up 22.2%, but the average Nasdaq stock was up only 2.9%, barely better than the yield on T-bills. Actually,

only four stocks comprise 25% of the entire value of the Nasdaq; they are Dell, Cisco, Microsoft, and Intel. The big stock phenomenon is one reason why I started my Big-Stock Breadth Index (BBI). It's the biggies that have been leading the various averages, and if you're not in 'em you're taking the risk without making the money.

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Wrote Paul Gigot in last week's *NY Times* regarding Clinton, "He has lied his entire career and been rewarded for it. He has learned that if he can persevere long enough, and smash back hard enough, he can survive." Now Clinton must face his worst nightmare; pols from both parties have urged him to "tell the truth" about Monica and have an end to the whole thing. What, Clinton tell the truth? He lied about avoiding military service, he lied about smoking marijuana, he lied about Gennifer Flowers, and here are pols from his own party begging him to tell the truth. Clinton voluntarily telling the truth? Forget it, it's against his character. After all, here's a man who's made an industry out of avoiding the truth about himself. The public, which has all along forgiven Clinton his lying, is finally becoming uncomfortable. **Russell Opinion:** If the stock market turns bearish, Clinton's popularity will melt like a cake of ice in the Phoenix sun.

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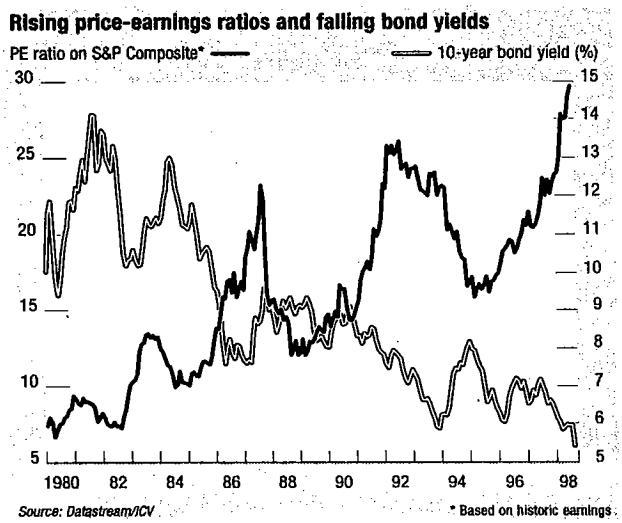
This chart (courtesy of the *Financial Times* of London) shows the surging price/earnings ratios of the S&P against the sliding yields of the 10-year US government bond. What the chart portrays is massive confidence. Which brings us to the "equity risk premium." The equity risk premium is defined as the expected excess return from holding stocks compared with bonds. The risk premium has dropped very low in recent years. According to Goldman Sachs, the equity risk premium has dropped from 10% in 1980 to 2% today. In other words, investors believe there is very little risk today in holding stocks rather than bonds. This sentiment is based pretty much on the "Goldilocks economy." But will the Goldilocks economy last? Let me put it this way -- it never has lasted in the past.



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Japan: Will Japan, which adheres to conservatism and a policy of resisting change, be able to climb out of its nine-year decline? Masaru Hayami, its central banker, is skeptical. Said Hayami, after the central bank lowered its assessment of the economy, "Our nation's economy has worsened. Capital investment and employment have declined, especially at mid-sized companies." One problem, if the central bank boosts the money supply the yen will weaken still more, pushing down market rates and reducing returns on yen-denominated assets. A weaker yen puts pressure on countries such as China, S. Korea, Malaysia and Indonesia. The latest news is that Japanese banks are now saddled with roughly one trillion dollars worth of bad loans, an amount double or quadruple what the Japanese banks have admitted to. The problem: the Japanese hate to lose face. To admit to these figures and deal with them will require a reversal of character (news clip from the *International Herald Tribune*).

Japan Sounds Alarm On Economy's Future

Central Bank Chief Becomes More Pessimistic

Compiled by Our Staff From Dispatches

TOKYO — Masaru Hayami, the Bank of Japan governor, said Tuesday

Mr. Hayami said the central bank had little room to lower interest rates to stimulate a recovery. He said policymakers had discussed a reduction of the target for

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The big fear continues to be whether China will be forced to devalue. With renewed yen weakness, the pressure on China has become intense. Most of Asia can now compete very successfully with China, and the weaker the yen, the more pressure on China's yuan. According to the Institute of International Finance, as things stand, China and Hong Kong could lose as much as $18 billion in sales to Asian competitors. Just as bad, the Asian crisis has turned off the spigot from the thousands of overseas Chinese who have been the main source of direct investment into the Chinese mainland. The flow has now been reversed and the overseas Chinese have pulled as much as $200 million a day out of mainland China in order to replenish their coffers at home.

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Silicon Valley in a slump? That seems to be the story. *Semiconductor Business News* calls 1998, "the worst year since at least 1985." The semiconductor industry, a bellwether of the entire industry's health, declined 9% in 1996, grew only 4% in 1997 and is slated to shrink 10% this year. Meanwhile, the rise of the "under-$1,000 computers" has meant a profit squeeze for many Silicon Valley firms. In turn, the PC manufacturers have put pressure on the chip suppliers and other component suppliers, thereby squeezing profits across the board.

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An increasing number of billionaires are buying huge spreads of land as an investment and actually as an aid to the environment. One of the uses they have put this land to is -- raising buffalo. Ted Turner alone over the last decade has purchased 11 ranches encompassing well over one million acres in Montana, New Mexico and Nebraska. His two southern New Mexico ranches alone cover half a million acres. Like the environmentalists whom Turner supports financially, Turner hopes to reestablish the wildlife that once flourished on the desert. **Russell Comment:** I've been a Cactus collector ever since I was a kid, and I can tell you that much of the US deserts have been desiccated by tourists, promoters, off-road vehicles and motorcycle racers. Furthermore, many rare Cacti have been removed or stolen from the deserts, and others have been ground-under by unscrupulous land developers.

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One of the **greatest predictions** of all time (by President Dwight Eisenhower): "This is going to take a long time, but if the Soviets want to keep up with us, they will have to educate their people, and in so doing they will sow the seed of their own destruction." **Russell Comment:** And that's exactly what happened.

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Financial news is everywhere, TV, radio, the Net, brokerage houses, newspapers. A huge struggle is now going on between Reuters, Bloomberg and Bridge. Bridge has been on a buying spree that has seen it buy Dow Jones' Telerate for half a billion dollars. A few weeks ago Bridge bought Automatic Data Processing for $150 million, which supplies real time equity prices. Bridge now has more terminals than Bloomberg, and it is thought that Bridge is passing Bloomberg and possibly Reuters as well. Meanwhile, Reuters has been moving heavily into bond data, thereby attacking one of Bloomberg's strongest areas. At the same time Bloomberg is moving more heavily into the retail area, increasing its presence on the Net and paying AOL to carry some of its data. **Russell Comment:** I use the Internet every day, mostly just for market closing data. Very frankly, I

don't find most of the comments and "inside info" that is carried on the Net that interesting or helpful. As far as I'm concerned, the technical data and the market action are what I look for.

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Last week my son, Ryan, age 20, called me from Berkeley, where he's going to college, to tell me he fell off his skate board and broke his elbow. He was operated on, the surgeon put some metal pins in his elbow, and he'll live. I thought of my son and then I thought about the movie, "Saving Private Ryan" (I can't get that film out of my mind), and I thought about all the guys who died back in the '40s, and all the parents who had to face the worst thing any parent can face, the death of a child. And I thought, thank God I don't have to worry about my son in another war.

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US combat deaths from various wars: Revolution -- 4,435; Civil War -- 400,414; World War I -- 53,402; World War II -- 291,557; Korean War -- 33,651; Vietnam War -- 47,378. Why the huge number of deaths during the Civil War? One reason, many wounds proved fatal since there were no anti-biotics in those days. In WWII we were all given packets of sulfa powder, plus morphine syringes. All wounds were immediately dusted with sulfa and morphine helped when you went into shock.

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And how about this. The US savings rate has sunk to almost zero. In the second quarter the US savings rate fell to 0.6% from 1.2% in the first quarter, according to the Commerce Dept. The savings rate for all of '97 was revised to 2.1% from the previously stated 3.9%. That's the lowest level since the Great Depression. The rate is arrived at by subtracting consumer spending from income. At the same time, the amount of cash that mutual funds hold is at a record low 3%. So consumers are bought up and the funds are loaded up. Wonder what would happen if things suddenly got tough?

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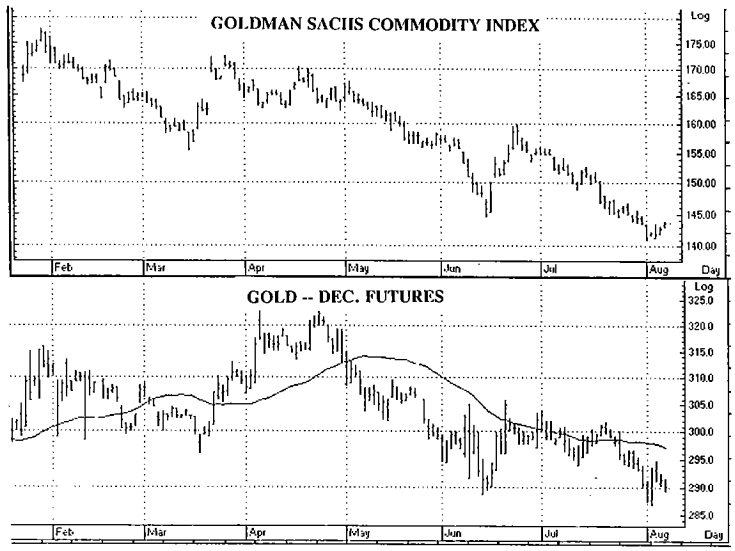
With the advent of electronic trading and Internet trading, the future of the stock exchanges comes into question. Already, a seat on the NYSE has dropped from a record $2 million to $1.35 million. In Chicago, the CBOT board on July 28 voted to allow electronic trading alongside of open outcry. **Russell Comment:** I see the entire brokerage industry moving toward brokerless electronic trading, with maybe a minimum of brokers to handle questions and give advice. My advice -- don't look to a future as a stockbroker, there's going to be massive shrinkage in this area.

PRECIOUS METALS, COMMODITIES: If we judge just by the price action, the world has moved into a deflationary environment. Almost every commodity is in a bear trend, from corn to soy beans, from wheat to cattle, from cocoa to crude oil. I'm including above a chart of Goldman Sachs' commodity index, and as you can see, it's "saying" deflation.

Strangely, the deflation has been limited somewhat to commodities and retail items (terrific competition in the latter), but the deluxe life still is running at full steam in NYC and in many areas of the West Coast. Actually, the retail public is usually the last to know that anything is wrong. Thus, workers are pushing for higher wages, top-priced restaurants have waiting lists, and sports figures continue to pull down monster salaries. All this will change as the bear market progresses.

Unfortunately, the precious metals are telling us the same thing that the commodities are telling us. It does seem that world deflation is the order of the day. Gold (December futures) has broken slightly below the 290 level. Hopefully (and that's all we have left -- hope), a bottom may be forming here. The 34-day moving average for December gold comes in at 296.20. The best action would be gold climbing above that level.

Meanwhile the gold shares seem to be sinking into oblivion. The most profitable gold share, Barrick Resources (ABX), has sunk into the 16-17 area, a level it hasn't seen in years. Mmmm, at this price you'd think Barrick was worth buying and just "putting away."



LATE NOTES: Joe Granville called me on August 6. He said, "Dick, I want to tell you about my 'one-foot rule.'" I replied, "Gad, Joe, I've known you for 38 years and you never told me about the 'one -footer.'" Said Joe, "Here it is. Whenever the list of new NYSE lows in the *WSJ* is longer than one foot, that's 12 inches, the market is over-sold and ready to rally. And on August 5 with 566 new lows, the *Journal* list was 13.5 inches long." Well, nobody can say that Joe isn't innovative. And there you have it, the "one-foot rule."

At the August 5-6 lows, the stock market was over-sold based on almost all "normal" (e.g., bull market) criteria. But if a major rally doesn't materialize from this area, then **something different** is occurring. **In a bear market,** an over-sold situation can be worked off by a process of the market churning, advancing feebly, backing and filling -- rather than advancing strongly. In other words, if the market doesn't do anything impressive on the upside coming out of this over-sold area, be careful. It will mean that an over-sold condition is simply being worked off, and the next major move will be down.

Consider this: All through the April-to-August period billions of dollars continued to flow into the mutual funds. And the funds in turn bought a lot of stock. Yet during that same period the A-D ratio literally crashed, and between July 17 and August 4 the Dow lost 850 points. How could that have happened? Simple -- the sellers over-powered the buyers. Who are these sellers? Nobody knows. But they are most definitely out there and they are very powerful and very anonymous.

Watch this! In the Chinese black market last week the US dollar surged to a new 1998 high against the yuan. Chinese black market traders were buying US dollars for 8.85 yuan and selling them for 8.9 yuan, which was about 7% over the official Chinese government rate. At the same time, in Hong Kong's black market, Hong Kong's dollar-linked currency came under new selling pressure. All this aroused new fears that China may be forced to devalue its currency.

Referring back to my **Big-Money Breadth Index (BBI),** you can see that the big stocks are most definitely the strength of the market. This bear market may batter many stocks, but the entire market is not going to "unravel" in earnest until the BBI nears or actually breaks to new lows. In my opinion, a new low in the BBI, when it comes, will be like pulling the foundation out from under this market.

Basic thought to remember in a bear market: **Values diminish through time** in a primary bear market.

NEXT MAILING: Aug. 26, 1998